



The Real Estate **ANALYST**

JUNE 23
1961

APPRAISAL BULLETIN

Volume XXX

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Number 26

Real Estate Economists, Appraisers and Counselors

CONDEMNATION AND THE INCOME TAX PROBLEM

OWNERS of real estate that is subjected to partial taking by condemnation are confronted with a tax accounting problem. This is particularly true when the award made for this partial taking includes severance damages to the part remaining as well as the value of that part taken.

In some States condemnors in making their awards in the case of partial takings seldom indicate to the property owner the amount allocated to the value of the part taken and the damages to the part remaining. From an income tax viewpoint this frequently leads to problems that could have been eliminated if the property owner had received a breakdown of the award. There is little doubt that the condemning authorities hesitate to make this allocation until the owner commits himself to a firm settlement. To make this known in advance of a firm award agreement would probably make the negotiators' job considerably more difficult. This need not be given prior to settlement. Nevertheless, owners should get a statement from the condemnor, the condemnation commission or the court, allocating the award between the value of the part taken and the severance damages to the remainder. This information is required to properly compute capital gains for income tax purposes if tax benefits are desired.

From an income tax standpoint, the award made in a partial taking may include a capital gain which should be reported as such when there has been appreciation in the value of the property. This capital gain should be reported in the year the award is made, but in order to establish the capital gain it is necessary for the taxpayer to establish the cost of that portion of the property that was taken. In the case of raw land or agricultural land it might be quite simple to equitably allocate the land on an acreage basis in order to place acquisition costs on that part taken. On the other hand, if it is improved urban land and had that characteristic at the time of acquisition, the allocation of the value may require the services of a qualified appraiser. The allocated original cost subtracted from the allocated award for the part taken would then represent capital gain, which should be reported as such for the year in which the award is made.

Severance damages to the remainder need not be reported as a capital gain but should be used to reduce the initial cost of that portion remaining. Clients should be warned not to discard the appraisals or the official allocation of the

award until they have disposed of the property and are sure that they will not have to show proof of their allocation to the Internal Revenue Service. In other words, capital gains would in effect be deferred until a later date when the property is sold, which might be many years after the condemnation procedure.

We are showing in this bulletin two possibilities of how this matter may be handled. Bear in mind that we do not claim to be tax accountants or lawyers. Your accountants and lawyers should be consulted in these matters. The first example is of a rural piece of property containing large acreage. The second example is on an urban residence that suffered the loss of most of its front yard.

ANALYSIS OF 160-ACRE DAIRY FARM

In this instance a limited-access highway severed the farm into two pieces -- a small piece of 30 acres which contained the homestead and farm improvements, including the milking sheds, the loafing barns, etc., and 129.38 acres of pasture land. Six thousand dollars of the \$6,248 award was considered as severance damages because it was not possible to operate a dairy farm with the milking facilities inaccessible to the severed pasture remaining of 129.38 acres.

In this example the 160-acre farm and improvements were purchased in August 1944 for \$150 per acre, or \$24,000. The award indicated a unit land value of \$400 per acre as of the award date. This, applied to the .62 acre taken for limited-access right-of-way, resulted in a value of the part taken of \$248.

Summarized below is the method followed in arriving at the capital gain without the necessity of having a historical appraisal made.

Purchased 8/8/44 - 160 acres @ \$150 = \$24,000

Condemnation award 8/16/59

Value part taken .62 acre @ \$400 per acre	\$ 248
Severance damages to remainder (Loss of value of dairy barns, etc.)	6,000
Total Award	<u>\$ 6,248</u>
Value of part taken:	\$ 248
Original cost of part taken - .62 acre @ \$150 per acre	93
Capital gain	<u>\$ 155</u>
Original cost of entire property	\$24,000
Less cost of part taken	93
Cost of part remaining	<u>\$23,907</u>
Less severance damages to remainder	6,000
Book cost of part remaining	<u>\$17,907</u>

(To be used for tax purposes - cost base when property is sold)

In the foregoing example, where the value of the part taken was of little consequence, it was not deemed necessary to have an appraisal made to justify the allocation of the purchase price to the part taken and to that part that remained. However, the following example shows the procedure in a more complicated urban partial taking.

ANALYSIS OF AN AWARD FOR THE TAKING OF THE FRONT YARD OF AN URBAN RESIDENCE

In this instance the award was considerable because of the taking of the front yard of a residence and the resulting damages to the remainder. The appraisers for the State and for the owner recognized the use of generally accepted depth tables in establishing the value of the front 40 feet being taken. The severance damages were due primarily to the loss in value of the residence because it no longer had a spacious front lawn, which is deemed practically necessary according to accepted residential standards.

This property was purchased in October 1951 for \$30,000 and has had inflationary increases since. The analysis on this property is given on page 304.

The examples shown do not take into consideration annual depreciation allowances for tax purposes that may have accrued on income-producing properties. That would reduce the book value even more. These examples merely demonstrate two of the acceptable methods of distributing the condemnation award. The appraiser, real estate counselor, accountant and lawyer should be aware of this problem in the years ahead with still greater amounts of condemnation anticipated for highway and urban renewal purposes.


WILLIAM J. RANDALL, M. A. I.

ANALYSIS OF AN AWARD FOR THE TAKING OF THE FRONT YARD OF AN URBAN RESIDENCE

Condemnation award:	
Value of part taken	\$ 1,900
Severance damages to remainder	6,600
Total Award	<u>\$ 8,500</u>

Distribution of cost (by appraisal)	
Land: 100 feet (front 40 feet = 32% of \$40 front foot)	\$ 1,280
100 feet (rear 160 feet = 68% of \$40 front foot)	2,720
Total land value - 100 feet @ \$40	<u>\$ 4,000</u>

Improvements:	
Residence, 1,500 sq. ft. depreciated value @ \$14.50	\$21,750
Porches, depreciated value	1,200
Garage, 2-car, depreciated value	1,500

Walks:	
In area taken 150 sq. ft. @ 30¢ = \$ 45	
In area remaining. . . 150 sq. ft. @ 30¢ = 45	90

Drive:	
In area taken 400 sq. ft. @ 25¢ = \$100	
In area remaining. . . 1,600 sq. ft. @ 25¢ = 400	500

Landscaping and lawn:	
In area taken	\$300
In area remaining	700

1,000
\$30,040
call \$30,000

Value of part taken:	
By award allocation	\$ 1,900
Original cost by appraisal:	

Land	\$1,280	
Walks	45	
Driveway	100	
Landscaping and lawn	300	1,725

Capital gain (to be reported)	<u>\$ 175</u>
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Cost and value of remainder:	
Original cost	\$30,000
Less cost of part taken	1,725
Cost of remainder	<u>\$28,275</u>
Less severance damages to remainder	6,600
Book cost of remainder	<u>\$21,675</u>

(To be used for tax purposes - cost base when property is sold)

